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Department of Agricultural and Consumer Economics, University of Illinois Urbana-Champaign

Buying and Selling Machinery Outright vs. Trade

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August 10, 2011

***farmdoc daily* (1):128**

Recommended citation format: Edlefson, N. "Buying and Selling Machinery Outright vs. Trade." *farmdoc daily* (1):128, Department of Agricultural and Consumer Economics, University of Illinois at Urbana-Champaign, August 10, 2011.

Permalink: http://farmdocdaily.illinois.edu/2011/08/buying-and-selling-machinery-o.html

A common issue that often comes up for many of our clients when they are considering machinery replacement is whether to buy the equipment outright and sell their existing piece or to trade with the dealership. One of the first things often thought of is the risk the producer holds by buying the new piece while still holding the older piece, and whether or not it will sell. This risk must be weighed with what is thought to be an appropriate trade in value, but one thing that is often not thought of is the tax advantages that may be realized via the outright sale of your existing piece.

This tax advantage is due to the fact that equipment sales for items listed on a depreciation schedule are shown as income on form 4797 of the tax return, while purchases are listed on the depreciation line of the schedule F for the sole proprietor farmer. For all income shown on a schedule F, self employment tax is imposed at a 13.3% rate for 2011 (up to a maximum level). Income from machinery sales on 4797 is not subject to self-employment tax, thus the potential for tax savings.

Let's assume the following scenario:

Producer John is contemplating the purchase of a used tractor to replace his old one. His dealer is asking $160,000 for the new used and willing to give $90,000 in trade for John's old machine, leaving a $70,000 trade in difference. John will show net income on his schedule F this year of $125,000. John believes his old tractor is clean and with the recent used equipment market that he has a decent chance to sell it outright for at least $90,000. Let's assume for simplicity's sake that John is single and has no other income sources (everyone's tax situation is different so tax savings will not come out the same for everyone).

With the trade in, John has the potential to show $70,000 (the cash boot trade-in) as a 179 expense election depreciation write-off on his schedule F reducing it to $55,000 taxable income. Estimated tax bill=$14,767

With buying and selling outright, assuming John sells his old tractor which is depreciated out for $90,000 and buys the new one for $160,000 (higher deduction on F). Estimated tax bill=$9,184

Obviously, this is just one example and every scenario much be treated differently, but it certainly poses a significant tax savings situation. But would it be enough to offset the risk of selling it outright for much less than what a dealer is willing to offer on trade-in? Holding on to an extra piece of equipment for a year could negate the tax savings.

In addition, the expense election limit for this year is $500,000 with maximum total purchases below 2 million. We are currently set to go back to a $125,000 limit on max of 500,000 in purchases in 2012.